

Internal Revenue Service

Department of the Treasury
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Date:

November 02, 2010

Legend

Taxpayer =

Sponsor =

Group Contract =

Certificate =

Number A =

Number B =

Number C =

Number D =

Dear :

Taxpayer has requested several rulings regarding the application of certain provisions of the Internal Revenue Code to a contemplated transaction.

FACTS:

The Taxpayer represents that:

The Taxpayer is a life insurance company within the meaning of § 816(a) of the Code, files its federal income tax return on a calendar year basis, and reports its income on an accrual method.

Sponsor is a wholly-owned subsidiary of Taxpayer. Sponsor offers investment advisory services to individuals and entities (Account Owner). Among the investment advisory services are Managed Accounts. With regard to a Managed Account, the amount deposited by the Account Owner is actively managed by Sponsor in a manner consistent with an agreed upon investment strategy. That is, the Account Owner does not direct any specific trading activity but rather that activity is left to the discretion of Sponsor, consistent with the strategy.

Taxpayer intends to issue Group Contract to Sponsor; the Group Contract authorizes Sponsor to designate certain persons to be eligible to purchase a Certificate. The eligible persons are expected to be certain Account Owners with Managed Account(s). The Group Contract indicates that the Certificate will describe the provided benefits and applicable limitations and conditions. The Group Contract indicates that the Certificate may be modified by a rider or endorsement attached to the Certificate. After being in effect for one year, the Group Contract can be terminated upon written notice; such termination will not apply to in-force Certificates.

When an eligible Account Owner acquires a Certificate, the Account Owner can select some or all of the assets held in the Managed Account as “Specified Assets.” With the non-discriminatory approval of Taxpayer, the Account Owner can subsequently select additional assets as Specified Assets.

The Specified Assets will be managed by Sponsor consistent with a “Specified Investment Objective” made available by Sponsor. The Certificate will indicate at issuance the Specified Investment Objective applicable to that Certificate.

After a specified Withdrawal Start Date, the Account Owner may withdraw an amount up to the Annual Withdrawal Amount (described below). In exchange for a Periodic Fee (described below), the Certificate obligates Taxpayer to provide Account Owner a guaranteed minimum benefit: if the value of the Specified Assets is exhausted through other than Specified Transactions (described below) after the Withdrawal Start Date, Taxpayer will commence monthly payments to Account Owner, for life, of the Certificate Benefit, which is equal to the Annual Withdrawal Amount.

The Annual Withdrawal Amount is set at issuance of the Certificate to be the lesser of \$ Number A¹ and Number B % of the value of the Specified Assets. The Annual Withdrawal Amount will be redetermined on each anniversary to be the greater

¹ This amount can be changed on a non-discriminatory basis.

of the prior year's Annual Withdrawal Amount and Number B % of the value of the Specified Assets on such anniversary. The Annual Withdrawal Amount will be increased by Number B % of the Annual Withdrawal Amount each year during the time beginning on the issuance of the Certificate and ending on the earlier of the Number C anniversary, the anniversary after the Account Owner attains age Number D, or the date the value of the Specified Assets reaches zero because of Specified Transactions (explained next).

Specified Transactions are those in which the Specified Assets are redeemed or transferred for a purpose other than paying the Periodic Fee. If, for example, the Account Owner wishes to reallocate the Specified Assets to an alternative Specified Investment Objective, such reallocation would be a Specified Transaction (unless the reallocation is because the prior Specified Investment Objective is discontinued). Another example of a Specified Transaction is exercise of the Certificate's annuity purchase guarantee.

If a Specified Transaction occurs prior to the Withdrawal Start Date, the Annual Withdrawal Amount is reduced by the ratio that the amount involved in the Specified Transaction bears to the value of the Specified Assets. If a Specified Transaction occurs after the Withdrawal Start Date, there are alternative effects. The Annual Withdrawal Amount is not changed if the amount involved in all Specified Transaction during the year is not greater than the Annual Withdrawal Amount. If the amount involved in all Specified Transactions during the year is greater than the Annual Withdrawal Amount, the Annual Withdrawal Amount is reduced by the ratio that the amount by which the Specified Transactions exceeds the Annual Withdrawal Amount bears to the value of the Specified Assets.

The Certificate is terminated if the value of the Specified Assets is reduced to zero before the Withdrawal Start Date; or, after the Withdrawal Start Date, if the sum of Specified Transactions occurring during a year exceed the Annual Withdrawal Amount and reduces the value of the Specified Assets to zero. Other causes of termination are death of the Account Owner, failure to pay the Periodic Fee, or other disposition of the Specified Assets.

The Certificate can be assigned.

The Periodic Fee is charged quarterly and is a specified percentage of the value of the Specified Assets.

The Certificate will be offered and sold only in states in which it has been approved for sale as an annuity contract, and such offer and sale will be pursuant to a registration statement filed with the U.S. Securities and Exchange Commission.

REQUESTED RULINGS

Taxpayer requests the following rulings:

1. The Certificate will be an annuity contract for federal income tax purposes.
2. The activities of Taxpayer in offering and issuing the Certificate will be within the scope of the “life insurance products” exception from the ‘mark-to-market’ rules of § 475 that is set forth in § 1.475(c)-1(d) of the Income Tax Regulations.
3. The Periodic Fee will be included in Taxpayer’s gross income under § 803(a)(1).
4. The Periodic Fee paid to Taxpayer will be taken into account in the determination of an Account Owner’s “investment in the contract” for the Certificate under § 72 and the Account Owner’s adjusted basis in the Certificate under § 1011.
5. If Taxpayer becomes liable to pay Certificate Benefits, such payments will be “amounts received as an annuity” under § 72(a).

LAW AND ANALYSIS

Requested Ruling #1

Section 72(a) provides that except as otherwise provided, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract. The Code does not otherwise define an annuity contract or “any amount received as an annuity.”

Section 1.72-2(a)(1) of the Income Tax Regulations provides that the contracts under which amounts paid will be subject to the provisions of § 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. Under §§ 1.72-1(b) and (c), as a general matter “amounts received as an annuity” are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date, a proportionate part of which is considered to represent a return of premiums or other consideration paid. Under § 1.72-2(b), amounts are considered as “amounts received as an annuity” only if all of the following tests are met: 1) the amounts must be received on or after the annuity starting date, 2) the amounts must be payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and 3) the amounts payable must be determinable either directly from the terms of the contract or indirectly from the use of either mortality tables or compound interest computations, or both (if the contract is a variable contract, § 1.72-2(b)(3) provides an alternative formulation of this requirement). Under § 1.72-4(b)(1), the annuity starting date is the first day of the first period for which an amount is received as an annuity; the first day of the first period for which an amount is received as an annuity shall be the later of 1) the

date upon which the obligations under the contract became fixed or 2) the first day of the period which ends on the date of the first annuity payment.

Explaining imposition of an “income-out-first” rule under §72(e) for withdrawals prior to the annuity starting date, the Senate report described a commercial annuity as

a promise by a life insurance company to pay the beneficiary a given sum for a specified period, which period may terminate at death. Annuity contracts permit the systematic liquidation of an amount consisting of principal (the policyholder’s investment in the contract) and income....An individual may purchase an annuity by payment of a single premium or by making periodic payments. A deferred annuity contract may, at the election of the individual, be surrendered before annuity payments begin, in exchange for the cash value of the contract....The committee believes that the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal.

S. Rep. No. 97-494 at 349-50 (1982)(footnote omitted). The report also explains § 72’s utilization of an exclusion ratio regime: “[a] portion of each amount paid to a policyholder as an annuity generally is taxed as ordinary income under an ‘exclusion ratio’ (§ 72(b)) computed to reflect the projected nontaxable return of investment in the contract and the taxable growth on the investment.” *Id.* As described in Samuel v. Commissioner, 306 F.2d 682, 687 (1st Cir. 1962), *aff’d* Archibishop Samuel Trust v. Commissioner, 36 T.C. 641 (1961), *acq.*, 1964-2 C.B. 3

[i]nherent in the concept of an annuity is a transfer of cash or property from one party to another in return for a promise to pay a specific periodic sum for a stipulated time interval....Again, in the normal annuity situation, once the annuitant has transferred the cash or property to the obligor and has received his contractual right to periodic payments, he is unconcerned with the ultimate disposition of the property transferred once it is in the obligor’s hands.

In Life & Health Insurance, Black and Skipper state that “[i]n the broadest sense, an annuity is simply a series of periodic payments” and while “[l]ife insurance has as its principal mission the creation of a fund [, t]he annuity, on the contrary, has as its basic function the systematic liquidation of a fund.” Accordingly,

[e]ach payment under an annuity may be considered to represent a combination of principal and interest income and

a survivorship element. Although not completely accurate, one can view the operation of an annuity as follows: If a person exactly lives out his or her life expectancy, he or she would have neither gained nor lost through utilizing the annuity contract.

Kenneth Black, Jr. and Harold D. Skipper, Jr., Life & Health Insurance 161-62 (13th ed. 2000).

Elsewhere an annuity has been described as “a right to receive fixed, periodic payments, for a specified period of time” and an annuity contract as

a contract under which, in exchange for the payment of a premium or premiums, the recipient thereof is bound to make future payments, typically at regular intervals, in amounts, to payees, and conditions specified in the parties’ agreement. The determining characteristic of an annuity is that the annuitant has an interest only in the periodic payments and not in any principal fund or source from which they may be derived. Although an individual who purchases an annuity remains the technical owner of the asset, he or she does not retain total control over that asset and does not have unfettered access to the full amount of his or her own “property”.

4 Am. Jur. 2d Annuities, § 1 (2008). Moreover, “[t]he purchaser of an annuity surrenders all rights to the money paid, and therefore installment payments of a debt, or payments of interest on a debt, do not constitute an annuity.” Id., § 2.

Whether an annuity contract allows the owner to access the value of the contract through other than periodic (“annuity”) payments is a product of state statute, Appleman on Insurance § 182:05[B][7] and [8] (2d ed. 2008).

Here, on balance the Certificate possess the essential attributes of an annuity. It is true that the Certificate may not, “at the election of the [Account Owner], be surrendered before annuity payments begin, in exchange for the cash value of the contract”, S. Rep. No. 97-464 at 349. It is also true that because the annuity starting date is contingent upon the value of the Specified Assets being exhausted while Account Owner is alive, it is not the case that “if [Account Owner] exactly lives out his or her life expectancy, he or she would have neither gained nor lost through utilizing the annuity contract”, Life & Health Insurance, at 162, but these conditions are not dispositive.

The Certificate and the amounts paid under the Certificate meet the requirements of §§ 1.72-1(b) and (c), 1.72-2(a)(1) and (b)(3), and 1.72-4(b)(1) as annuity contracts and annuity payments. Additionally, the Certificate is purchased “by making periodic payments” of premium for “a promise by a life insurance company to pay the beneficiary a given sum for a specified period, which period may terminate at death”, and is “used to provide long-term income security.” S. Rep. No. 97-464 at 349. Moreover, it has “the determining characteristic ... that the annuitant has an interest only in the periodic payments and not in any principal fund or source from which they may be derived.” 4 Am. Jur. 2d Annuities, §1. The Account Owner will have “surrender[ed] all rights to the money paid”, thereby distinguishing the Certificate from “installment payments of a debt, or payments of interest on a debt”, which are not annuities. Id.

The Certificate is not a contract to pay interest. See § 1.72-14(a).

Accordingly, the Certificate will be treated as an annuity contract within the meaning of § 72.

Requested Ruling #2

Section 1.475(c)-1(d) provides that:

(d) *Issuance of life insurance products.*—A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term *life insurance product* means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702. (emphasis original)

The Certificate is an annuity contract under § 72 and therefore Taxpayer, as the Certificate issuer, will not be subject to the “mark-to-market” rules of § 475 by reason of its issuance of the Certificate. The activities of Taxpayer in offering and issuing the Certificate will be within the scope of the “life insurance products” exception from the “mark-to-market” rules of § 475 that is set forth in § 1.475(c)-1(d).

Requested Ruling #3

Section 803(a)(1) provides that for purposes of part I of subchapter L, the term “life insurance gross income” means the sum of, among other things, the gross amount of premiums and other consideration on insurance and annuity contracts.

Prior to the revision of the life insurance company tax provisions by the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494 (1984), the controlling provision

was § 809(c)(1). This provision was interpreted by § 1.809-4(a)(1)(i), which provided that

The term “gross amount of all premiums” means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of § 1.809-5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)).

The Group Contract and Certificate echo a transaction described in Rev. Rul. 77-85, 1977-1 C.B. 12, which held that old § 809(c)(1) required the company to include in premium income the amounts received by the insurance company as

an annual market value premium equal to a specified percentage of the year-end value of the account. The market value premium compensates the insurance company for its cost and for its risk assumed in guaranteeing to the policyholder an annuity rate under the contract.

Rev. Rul. 92-94, 1992-2 C.B. 144, notes that “the regulations issued under pre-1984 §§ 809(c)(1) and (d)(11) of the Code continue to provide guidance for the interpretation of § 803(a)(1) and 805(a)(8).”

Here, as explained with respect to Requested Ruling #1, the Certificate will be treated as an annuity contract for purposes of § 72. Hence the Periodic Fee should be included in Taxpayer’s gross income under § 803(a)(1).

Requested Ruling #4

Section 72(c)(1) provides that, for purposes of the exclusion ratio under § 72(b), the “investment in the contract” as of the annuity starting date is the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income. Under § 72(c)(2), this amount is then reduced by the value of the refund feature, if any.

Section 72(e)(6) provides that for purposes of § 72(e), the “investment in the contract” as of any date is the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income.

Section 1011(a) provides that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under § 1012 or other applicable sections), adjusted as provided in § 1016.

Accordingly, The Periodic Fee paid to Taxpayer will be taken into account in the determination of an Account Owner’s “investment in the contract” for the Certificate under § 72 and the Account Owner’s adjusted basis in the Certificate under § 1011. See, e.g., Rev. Rul. 2003-76, 2003-2 C.B. 355 (addressing the allocation of the investment in the contract and the basis in the contract after the exchange of a portion of an annuity contract under § 1035(a)(3)).

Requested Ruling #5

For the reasons explained with respect to Requested Ruling #1, if Taxpayer becomes liable to pay Certificate Benefits under the Certificate, such payments will be “amounts received as an annuity” under § 72(a).

RULINGS

Based on the foregoing,

1. The Certificate will be an annuity contract for federal income tax purposes.
2. The activities of Taxpayer in offering and issuing the Certificate will be within the scope of the “life insurance products” exception from the ‘mark-to-market’ rules of § 475 that is set forth in § 1.475(c)-1(d) of the Income Tax Regulations.
3. The Periodic Fee will be included in Taxpayer’s gross income under § 803(a)(1).

4. The Periodic Fee paid to Taxpayer will be taken into account in the determination of an Account Owner's "investment in the contract" for the Certificate under § 72 and the Account Owner's adjusted basis in the Certificate under § 1011.
5. If Taxpayer becomes liable to pay Certificate Benefits, such payments will be "amounts received as an annuity" under § 72(a).

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings and it is subject to verification upon examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/

Sheryl B. Flum
Branch Chief, Branch 4
(Financial Institutions & Products)